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UNCLAS SECTION 01 OF 03 BRASILIA 000490

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NSC FOR BREIER, RENIGAR
TREASURY FOR OASIA - DAS LEE AND FPARODI
STATE PASS TO FED BOARD OF GOVERNORS FOR ROBITAILLE
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E.O. 12958: N/A
TAGS: ECON EFIN PGOV EINV BR
SUBJECT: BRAZIL - HOW MUCH SPENDING SEQUESTRATION IS ENOUGH?

REF: A) Brasilia 43
B) 04 Brasilia 291
C) 04 Brasilia 1098
D) Brasilia 387

¶1. (SBU) Summary. The GoB is preparing to issue on February 25 a decree sequestering Reals 5 to 10 billion (approximately USD 2 to 4 billion) of spending called for in the 2005 budget law passed by the Brazilian Congress December 29. This is part of an annual exercise in which the executive branch walks back some of the spending and revenue assumptions made by the Congress in the budget law to reflect its own evaluation of the likely fiscal scenario for the year. This is a precautionary exercise, and the money may ultimately be spent. In 2004, the Congress's projections proved to be much closer to the mark than those the GoB used to justify its February sequestration of about Reals 7 billion in expenditures, all of which was later spent. The biggest wildcard this year is the social security deficit. Recent projections of healthier social security contributions, due to increasing employment, may significantly reduce the amount the GoB sequesters on February 25. End Summary.

¶2. (U) The Brazilian Congress passed on December 29 a Reals 482.5 billion federal budget (ref A). As is traditional, the Congress topped up both revenue and spending levels from the budget proposal that the Executive submitted (see chart 1 below). The Congress is free to indulge in this political maneuvering because execution of the budget as passed by Congress is not mandatory, but rather serves merely as an authorization -- something that newly elected speaker of the Chamber of Deputies Severino Calvacanti says he wants to change (ref D). The executive, however, currently retains responsibility, under the Fiscal Responsibility Law, to sequester spending (within thirty days of the signing of the budget) to match its own revenue projections. While this has been invaluable tool for the GoB to enforce fiscal discipline and meet its primary fiscal surplus targets, the process places squarely on its shoulders, and not those of Congress, public opprobrium over spending cuts. The system also creates significant gaps, both positive and negative, between what the executive branch proposes, what the Congress passes and what is ultimately executed.

Chart I - Brazil's Budget
Billions of Reals

	2004 1st Rev	2004 As Executed	2005 Budget Proposal	2005 Budget Law
Total Revenue	406.1	424.5	457.4	482.5
(% of GDP, approx)		23%	23.5%	24.3%
- Transfers to States & municipalities	62	65.1	69.9	78.3
Net Revenue	344.1	359.4	387.5	404.1
Expenditures	344.1	361.2	389.5	404.1
- Payroll	84.3	88.6	90.3	91.3
- Other non-discretionary	32.2	30.9	32.1	36.3
- Judicial and Legislature Expenditures	3.7	3.3	4.6	4.6
- Social Security Benefits	121.5	125.8	140.0	140.0
- Discretionary	60.8	62.6	77.2	84.6
- Primary Surplus Target	41.6	50	45.3	47.3

Source: Ministry of Planning and Budget

¶3. (SBU) Ana Teresa Holanda, the director of the Office of Fiscal Affairs in the Ministry of Planning and Budget, told Emboff February 3 that the GoB is preparing to sequester about Reals 10 billion in spending to adjust the budget law for more recent projections of revenues. This compares to about Reals 7 billion sequestered last year (ref B). Further adjustments can be made throughout the year to reflect actual revenues. For example, the GoB later spent the Reals 7 billion it sequestered early in the 2004 when strong economic growth and changes in the PIS/COFINS taxes boosted revenues significantly. Holanda was uncertain what categories of spending would bear the brunt of the sequestration. The 2004 sequestration primarily reduced expected investment spending.

Table II
Social Security Deficit
Reals Billion

2003 Executed	24.5 (1.99% of GDP)
2004 First Review	28.3
2004 Executed	32.0 (1.9% of GDP)
2005 Budget Proposal	32.3
2005 Budget Law	32.3 (1.55% of GDP)
January 2005 projection	40.9
February 2005 projection	35.5

Source: Ministry of Planning and Budget

¶4. (SBU) The social security deficit currently is the biggest wild card for budget planning, according to Holanda. The 2004 deficit had come in Reals 3.7 billion above projections, and the GoB had estimated in January that the deficit could jump to Reals 40.9 billion. This Reals 8.6 billion increase represents the lion's share of the Reals 10 billion sequestration, she said. The primary culprit for the increased deficit had been an unexpected flood of small claims court decisions requiring readjustment of benefits to beneficiaries whose pensions were not indexed correctly in the switch to the new currency at the beginning of the Plano Real in 1994.

¶5. (U) The GoB has since come out with another social security deficit projection, this one of Reals 35.5 billion. This rosier estimate is based on higher projections of revenues, reportedly justified by strong job growth and falling unemployment, which should increase social security revenues. If adopted, the lower social security deficit projection could justify reducing the amount to be sequestered, by as much as Reals 5 billion. The GoB would need to weigh, however, the possibility that another major pending court decision on the calculation of social security benefits will be decided against it. The GoB has lost this case at the appellate court level. If the Supreme Court upholds that earlier decision, this would force payment of a reported Reals 6.8 billion in back benefits and increase monthly outlays by Reals 105 million.

¶6. (SBU) Comment: The positive news on economic growth and expectation of continued strong revenue performance have helped make the sequestration process this year remarkably low key. This stands in sharp contrast to last year, when the GoB was subject to routine attacks over its sequestration of investment spending. It is clear, however, that the social security deficit remains a significant fiscal vulnerability. While the deficit may fall as a percent of GDP this year (as it did from 2003 to 2004), even the healthy social security revenues projected for 2005 would cover barely a quarter of social security outlays. Clearly, the system requires further reform to reduce its vulnerability.

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